Ratings and regulation

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Thank you, Steve, Bob and the other BIS organisers for giving me an opportunity to share some thoughts about sovereign credit ratings, and about the interplay of regulation and the credit ratings industry more broadly.

For a long time now, I have been observing the credit rating industry and contemplating its regulation and role in the financial markets. In 1994, while at the Federal Reserve Bank of New York, Frank Packer and I wrote an article identifying what we perceived to be a structural problem in the industry and a way to fix it.[2] At about the same time, Moody's was independently communicating similar views on the same topic.[3] As there was a coincidence of views, it was perhaps unsurprising that I ended up joining Moody's in 1997.

The adverse consequences of regulatory reliance on ratings

Our main concern was a disturbing trend towards the increasing use of ratings in regulation and we put forward the obvious recommendation that the trend be reversed. The growing use of ratings in regulation had given rise to three potentially adverse industry dynamics: (i) the substitution of regulatory demand for investor-driven demand for ratings, (ii) the growing perception that ratings were something more than an opinion as a result of their official recognition by regulators, and (iii) a vicious circle of intrusive regulation to induce ratings and rating agencies to behave in line with regulatory needs, potentially changing the nature of ratings. My discussion today will focus on the interaction of these dynamics, the observation that they remain in play today, and an exhortation to regulators that they should rapidly seek to address the root cause, the continued mechanical use of ratings in regulation in various jurisdictions.

First, the use of ratings in regulation has the potential to disturb the industry's competitive dynamics by introducing a dimension to the demand for ratings that is independent of rating quality. Debt issuers historically sought ratings from credit rating agencies because such opinions were the most respected by investors. Although there have never been more than three or four major rating agencies at a time since 1920, a large number of additional rating providers have always been active at the competitive fringe of the market, standing ready to supplant the larger

1 Chief Credit Officer, Moody's Investors Service.

2 R Cantor and F Packer, "The credit rating industry", *Federal Reserve Bank of New York Quarterly Review*, vol 19, no 2, 1994.

3 Moody's has been a vocal opponent of the use of ratings in regulation since at least the mid-1990s. For an example of a statement of Moody's views, see Moody's letter to the SEC in response to its "Concept release on rating agencies and the use of credit ratings under the Federal Securities Laws", 28 July 2003.

incumbents if the smaller players could convince investors that they produced higher-quality ratings.[4]

The integrity of these competitive dynamics, however, was threatened by the growing use and importance of ratings in regulation. First, as Frank Packer and I – and Moody's – warned, the use of ratings in regulation introduces a source of issuer (and investor) demand for ratings that is independent of ratings quality; there is a risk that the demand for ratings quality is supplanted by a demand for products that are rated sufficiently high to meet a regulatory threshold.

Second, with official recognition of rating agencies and their ratings, there is a legitimate concern that investors may become less diligent in their own underwriting of individual credit risks and in their own evaluation of the reliability of ratings from different credit rating agencies. Interestingly, to date, little evidence has been put forward in support of this hypothesis. In fact, a broad survey taken shortly before the onset of the financial crisis reveals that very few asset managers and pension fund managers in either the United States or Europe have cited the use of ratings in regulation as a primary reason for the use of ratings in their bond portfolio investment guidelines.[5] Moreover, it is my understanding that virtually every large asset manager in the world has its own extensive credit department and assigns its own internal ratings to its large credit exposures. Nevertheless, it is clear that regulatory reliance on ratings increases the perception that some investors may use ratings to the exclusion of their own credit analysis.

Third, the regulatory use of ratings creates an adverse industry dynamic in which the ratings industry becomes increasingly regulated, threatening the independence of rating agency opinions, discouraging investors from undertaking their own credit assessments, and reducing investors' independent assessments of rating agency quality. Why? If some ratings are going to be officially recognised by regulators, there must be an objective standard by which regulators can determine whether a rating agency's ratings and processes can be acceptable for regulatory purposes. However, the establishment of such standards raises a number of problems. Objective criteria against which to judge the quality of ratings are widely recognised as being difficult, perhaps even impossible, to establish.[6] Instead of basing official recognition on a comparison of ratings performance, regulators inevitably have relied heavily on regulation of the ratings process, and by doing so,

[4] While the dominant business model with the industry is one in which the issuer pays for the ratings, issuers have historically been only interested in ratings that were valued by investors; issuers had good reason to eschew ratings from agencies with reputations for inflated ratings. The importance of reputation for ratings demand and the contestability of the market have been demonstrated repeatedly. In mid-1980s, the predecessor of today's Fitch Ratings essentially went out of business due to a loss in issuer demand for its ratings as a result of investors' perceptions that those ratings were inflated. Today's Fitch is a completely different company, which set out in the late 1980s to convince investors that it produces high-quality research and ratings, and thereby to generate issuer demand for its ratings. Moreover, in the mid-1990s, Fitch was able to acquire Duff & Phelps, another rating agency where demand for ratings was waning due to concerns about its ratings quality.

[5] See, R Cantor, O Ap Gwilym and S Thomas, "The use of credit ratings in investment management in the U.S. and Europe", *Journal of Fixed Income*, 2007, pp 13–26.

[6] The only reliable test of rating quality is to compare long track records of different rating agencies involving very large data sets of ratings on <u>common</u> issues and issuers, observed at the same points in time. Ratings assigned to different issuers, in different industries, and in different regions cannot be directly compared because credit shocks occur frequently across industries, regions and time and tend to dominate performance measures.

they have run the risk of intruding on the formation, communication and timing of the ratings opinion itself.

Worryingly, there would also seem to be a tendency on the part of regulators to also seek to substitute their own credit views for those of the rating agencies. That is to say, requirements have been imposed by regulators that rating methodologies include certain inputs. As a result, regulators are replacing an industry dynamic in which investors select among rating agencies based on their perception of the relative quality of their ratings with one in which regulators treat rating agencies as equivalent as long as they follow a particular set of processes that may have little relation to ratings quality. Rating agencies risk substantial sanctions if they err in following these processes, irrespective of their ratings performance.

Such an environment discourages attempts by rating agencies to improve their analytical approach or to compete on ratings quality, because as long as they follow the set procedures their ratings will be used for regulatory purposes. More problematic still, the environment could be viewed as penalising independent rating opinions because rating agencies can reasonably expect that their rating processes will draw additional regulatory scrutiny if they issue politically controversial rating opinions.

Progress on reducing regulatory reliance outside the United States has been limited

I have revisited what is likely very familiar ground for this audience because reducing mechanistic regulatory reliance represents a critical step for the credit rating agency industry and for the broader market. And while the Financial Stability Board has strongly made this recommendation, and the United States has done a very good job of removing the use of ratings in regulation fairly widely, it seems as if the Basel Committee lacks a plan to achieve similar results. Moreover, some of the regulatory developments occurring now in Europe might be seen by some as strengthening the role of ratings in regulation over time.

An aside: what is the impact of credit rating changes on CDS spreads?

There's a lot of passion around the topic of sovereign ratings, with good reason. From an academic perspective, however, the interesting questions about sovereign ratings are the narrower, more technical, and less political ones. In terms of power, the IMF and others have noted that sovereign credit ratings have proven roughly as predictive of defaults as have corporate credit ratings. Rating agencies have achieved this accuracy while maintaining sovereign ratings that are generally more stable than corporate ratings – and of course much more stable than credit risk assessments implicit in the market prices of sovereign debt.

There remain some open academic questions about the impact of rating actions on market spreads. Among them, do rating agencies' sovereign rating actions influence credit spreads and, if they do, by how much? Do they increase or dampen market volatility? The other members of this panel have conducted research on these topics, so I will touch on them only briefly.

If spreads are influenced by sovereign credit ratings but the impact follows from investors' reappraisals of a sovereign's credit risk in the light of the rating agency's rating rationale – ie a commentary shared by the rating agency and the investor – I would imagine that most people would be comfortable with the role that ratings are playing. But to the extent that rating changes impact credit spreads because of investors' mechanistic uses of ratings, then I think we would all agree that we have a potential source of market inefficiency.

Now, where might there be such a mechanistic use of ratings? It is very uncommon among sovereign investors,[7] although there still may be areas where you see such a reliance on ratings on the regulatory side. In general, if you survey investors, you find that institutional investors and large investors do not employ ratings in a highly mechanistic way There may be situations where, if an issuer's rating falls below a certain threshold, an asset manager would be expected to review the credit and possibly ask the end investors whether they want to continue holding the credit or not. But it is very rare to find asset managers who simply must sell a bond when an issuer is downgraded; certainly, this is the case for sovereign bonds.

On the regulatory side, however, there remain pockets where sovereign credit ratings are used in a mechanistic way. Managers of central bank reserves, for example, may be uncomfortable making politically awkward independent judgments on sovereign credit quality.

In the exhibit below, I present a summary slide from our latest sovereign rating change event study.[8] Here we indicate what happens on average to CDS spreads when there is a change in a Moody's, S&P, or Fitch sovereign credit rating, outlook, or watch listing. This is a standard event study chart, detailing what happens on average around positive and negative credit events. If you follow the event study literature on corporate credit ratings, you will recognise that the results for sovereign credit ratings are virtually the same as those for corporate credit ratings.

Positive rating actions have no observable contemporaneous effects, that is there is no particular trend in spreads around the time of these rating actions. For negative actions, there is perhaps a small spread change around the date of the rating action, but nothing particularly impressive. There is certainly a trend of spreads rising both before and after the rating action, suggesting the hardly surprising result that negative rating actions are sometimes taken during periods in which the market and rating agencies are learning new adverse credit information about the sovereign.

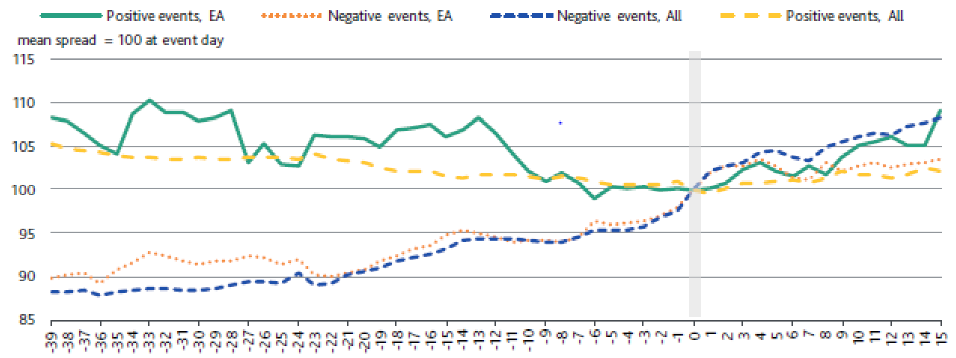
Note that none of these studies control for other credit events that may be affecting the sovereign might on or around the date of the rating action; that is, the data is contaminated from an event study point of view. For example, on the days when Moody's sovereign rating actions were reported by some observers to have

[7] There were reports that some investment guidelines in US bond funds called for investment in US government debt only if it carried both an Aaa rating from Moody's and an AAA rating from S&P. However, upon S&P's downgrade of the US sovereign, fund managers were able to obtain permission to relax these guidelines within 24 hours and there was no forced selling of US debt; in fact, spreads on US debt fell around the time of S&P's downgrade.

[8] "The price impact of sovereign rating announcements", *Moody's Special Comment*, 20 August 2012.

had the biggest impact on the market, there was also rioting on the streets of Athens and statements by various European officials that the EU should not provide financial support to certain European sovereigns. On days like this one, it is very hard to disentangle what causes spreads to move.

Mean spreads by type of rating announcement



Source: MarkIt, Reuters and Moody's calculations.

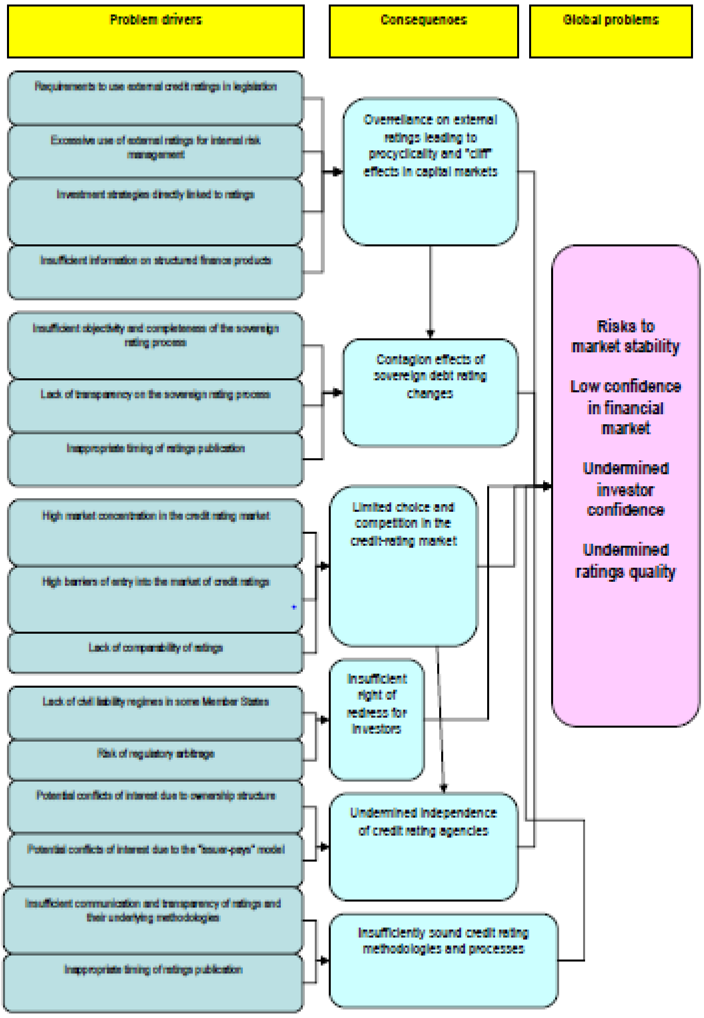
In any event, the spread changes associated with rating actions are clearly very modest. People interpret this data in multiple ways. Some say this data confirms their view that sovereign rating changes are irrelevant, because, in the case of sovereigns, all relevant credit information is public and widely analysed. Moreover, ratings aren't used mechanistically in the sovereign area, so why should there be an effect?

Others interpret this very limited price impact for sovereign rating actions as evidence that rating agencies have been successful in transparently communicating their methodologies, research and, signally, where ratings are heading. In this latter case, it can be argued that, on the day of the rating action, the real news is not the action itself but the other information embedded in the agency's press release, which signals the likelihood of further positive or negative actions thereafter. If you were to ask me what direction I expected sovereign CDS spread to move on the day of a Moody's rating action, I wouldn't be able to tell you until after I had read the press release and reviewed this information.

CRA3 and additional regulation of European sovereign credit ratings

As I mentioned earlier, one round of regulation frequently gives rise to another without a clear end in sight. After two rounds of legislation in the United States, ending in Dodd-Frank, the EU has now completed its third round of regulation within as many years. CRA3 was designed to address the perceived "problem tree" presented below.[9] The interplay between sovereign credit ratings and credit markets therein described probably reflects more the heated emotions around the topic than cold science.

[9] "Executive summary of the impact assessment accompanying the documents, proposal for a regulation amending regulation (EC) no 1060/2009 on credit rating agencies", *European Commission Staff Working Paper*, 15 November 2011.



Among the many new requirements laid out in CRA3 with respect to sovereign credit ratings, rating agencies will have to pre-commit to a schedule of ratings announcements, at most three per year for unsolicited sovereign ratings, so limiting their opportunities to comment. Moreover, sovereign rating actions can only be released after the sovereign has had the information for a full business day. While this added time will give the sovereign more opportunity to prepare its response, it will further compound the difficulties sovereigns have had in the past of keeping that information from leaking. Accompanying each rating action, rating agencies will need to present a detailed report containing many predetermined features.

I note that the report must comment on eight specific factors: "per capita income, GDP growth, inflation, fiscal balance, external balance, external debt, an indicator for economic development, an indicator for default". Frank Packer and I wrote a paper in 1996 that lists these same eight factors in the same precise order, word for word, without a single letter changed.[10] Thus, EU regulation now requires all rating agencies to give explicit public consideration for a backward-looking framework, presented in a 15-year-old research paper by two economists who, at the time, knew virtually nothing about sovereign credit risk.

[10] The factors appear on page 40 in R Cantor and F Packer, "Impact and determinants of sovereign credit ratings", *Federal Reserve Bank of New York Quarterly Review*, October 1996, pp 37–54.

The most positive aspect of CRA3, in my opinion, is a plan to establish at some point in the future a European agency to cover sovereign ratings. Perhaps when that plan is realised, regulators will be more comfortable in eliminating their reliance on private credit ratings and in scaling back some of the less productive industry regulation.